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THE IMPACT OF RATE OF RETURN AND INTEREST RATE ON ISLAMIC BANKING DEPOSITS AND CONVENTIONAL BANKING DEPOSITS

BY

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ABSTRACT

This research is mainly focused on the factors influencing the public investment in the Islamic Mudarabah deposits in comparison with the conventional fixed deposits. Rate of return was used as the major factor in the statistical analysis section in determining the growth rate of Mudarabah deposits as opposed to conventional fixed deposits. It was discovered in this research paper that rate of return is not the major factor for customers to invest in Mudarabah deposits as with the conventional fixed deposits. Instead there are other non-quantitative factors which are negligible in contributing to public investment in the Mudarabah deposits.

CHAPTER 1

HISTORY AND BACKGROUND

1.1 Introduction

Islamic banking started taking roots in Malaysia in early 1960s. The first Islamic financial institution in Malaysia was the Muslim Pilgrims savings Corporation set up in 1963 to help people save for performing hajj (pilgrimate to Mecca and Medina). In 1969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The Tabung Haji has been acting as a finance company that invests the savings of the would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which represents a full fledged Islamic commercial bank in Malaysia (Ariff 1988).

The Bank Islam Malaysia Berhad ("BIMB") was the first Islamic Bank to be established in Malaysia under the provisions of Islamic Banking Act of 1983 (Act 276) of the Malaysian parliament. This act provides the Central Bank of Malaysia with powers to supervise and regulate Islamic Banks in Malaysia. BIMB was incorporated on March 1, 1983 and commenced operations on July 1, of the same year. Since then Malaysia has steadily moved towards the establishment of a dynamic Islamic financial system in the country side by side with the conventional system.

BIMB is not only actively promoting Islamic banking products through its own operations but is also involved in introducing Islamic financial products and services through its own subsidiaries. Currently, BIMB has subsidiaries dealing with leasing businesses, nominee services, family and general takaful (insurance) business, trust funds and stockbroking.

A momentous event in the growth and development of Islamic banking took place in Malaysia when the Interest-Free Banking Scheme or Skim Perbankan Tanpa Faedah ("SPTF") was launched on March 4, 1993. Under this scheme often known as 'Islamic Windows', all commercial banks, merchant banks and finance companies are allowed to offer Islamic Banking products and services.

In the first phase of this scheme, three largest commercial banks in Malaysia namely Malayan Banking Berhad, Bank Bumiputra Malaysia Berhad and United Malayan Banking Corporation were authorised to conduct interest free banking activities. The second phase commenced on August 21, 1993 with 10 more financial institutions participating in the scheme. At the end of 1994, 21 conventional commercial banks had been given approval by Central Bank of Malaysia to offer interest-free banking scheme.

Finally, in the third phase of the scheme, all commercial banks in Malaysia were placed under the purview of interest-free banking scheme. In principle, all commercial banks, merchant banks and finance companies are eligible to participate in the SPTF. Hence, with the implementation of this scheme, Malaysia has emerged as the first country to implement a dual banking system of which Islamic banking system functioning on a parallel basis with the conventional system.

However, Bank Negara Malaysia (BNM) has on December 1, 1998 abolished this scheme and converted to a new scheme known as Islamic Banking Division.

In January 1994 the first Islamic interbank monetary system was introduced in the Malaysian financial system. The Islamic Interbank market comprises three elements namely (i) interbank trading in financial instruments, (ii) Islamic interbank investments and (iii) Islamic interbank cheque clearing system.

BIMB currently has an authorised and paid up capital of RM. 500,000,000 and RM. 133,405,001 respectively. In 1983, the Bank had started with a paid up capital of RM. 80,000,000 whereby at the time it enjoyed monopoly position in the domestic market of Islamic Banking. The government of Malaysia has contributed 37.5% of the bank's paid up capital. The other major shareholders comprise Pilgrims' Management and Fund Board (Tabung Haji), Muslim Welfare Organisations of Malaysia, State Religious Council, State religious agencies and other Federal Agencies. BIMB has made impressive growth and progress during the period 1983 to 1993.

By 1993, its assets had grown to RM. 2,009,088,000 while its deposits had risen to RM. 1,611,682,000. Total amount of customer financing stood at RM. 1,014,104,000 with 57 branches all over the country. By 1997, total assets and deposits of the Bank had increased by 141% and 130% respectively to RM. 4,853,679,000 and RM.

3,716,541,000 respectively. Total amount of customer financing had risen by 148% to RM. 2,517,744,000. Total shareholders' funds of BIMB stood at RM. 317,815,000 in 1997 as compared to RM. 279,335,000 in 1996.

1.2 Problem Statement

With Malaysia enjoying rapid economic growth for the past 10 years, many may wonder how much income they can save in view of the higher cost of living today. Fortunately in Malaysia, the pension and provident funds initiated by the government such as EPF and Socso have successfully made people to save compulsorily and therefore help raise domestic savings. At the micro level, individuals who save more may have a higher sense of security and perhaps self-esteem. But people can only save if they have reached a certain level of living standard.

The level of savings is said to depend on the level of income, that is, the higher the income, the higher is the level of savings. The high rate of national savings is thus largely attributed to Malaysia's rapid economic growth. This is because as the economy grows rapidly, income increases thus increasing the level of savings. More savings would mean more money available to produce capital goods such as machines, plants and factories. The question now is what will it take to push people to save more in the domestic financial market.

Unfortunately today, saving in the stock market seems more palatable to Malaysian households who represent more than 70% of the investors. They also prefer to save and invest in property while the relatively new unit trust industry is still struggling to find customers. Hence, this will leave us with the savings and fixed deposit products in the banking industry. But given the low rates of return on deposits today, is the banking sector an attractive place for people to save? The answer is even more problematic when it concerns the interest-free banking system (SPTF). Besides the level of income, the other possible factor determining the level of savings is the rate of return.

In view of that, this research paper is mainly to study the pattern of savings of Malaysian household when the rate of return varies. This research paper will focus on the pattern of savings in the Islamic Mudarabah deposits in comparison with the conventional fixed deposits.

1.3 The Objective of the Study

a) To study the relationship between the rate of return and the growth rate of Mudarabah deposits

b) To study what are the other factors influencing the growth of Mudarabah deposits.

c) To study the relationship between the rate of return and the growth rate of conventional fixed deposits.

1.4 Limitation of Study

The researcher encountered some difficulties in completing this research paper. The study is involved with the collection of primary and secondary data, therefore longer time is needed to do a better research. Time constraint was the main factor limiting the researcher to do a detailed study which could influence the research and analysis. The researcher faced difficulties in making appointment with some of the Islamic

Banking division managers or officers in charge of Mudarabah deposits for personal interview. Researcher has distributed a total number of 100 questionnaires to the Islamic Banking Division of 5 commercial banks in order to gather feedback from their customers. However, researcher only managed to obtain feedback from 60 respondents. Besides that, there is a mismatching of data whereby the required data for Mudarabah deposit is available from 1994 to 1998 but the required data for conventional fixed deposits is only available from 1994 to 1997. Hence in order to stream line the data analysis between Mudarabah deposits and conventional fixed deposits only data from 1994 to 1997 was taken for analysis purposes.

1.5 The Importance of the Study

The study on Islamic banking in Malaysia would benefit several categories of people which include the local business community, the bankers, the students and the public.

Local businessmen particularly the small and medium scale industries (SMI) would be able to know the alternative avenue of financing for their business operation from this study. Bankers from the conventional banking system would have a clearer picture and understanding of the Islamic banking services which is operated on a parallel basis with their conventional banking services.

Last but not least, this study would furnish the students and the public with the information regarding the growth, operations and the salient characteristics of Islamic banking in Malaysia.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Islamic banks are considered as the end product of the Islamic resurgence which emerged within Islamic societies particularly during the end of 1960's and early 1970's. One of the most important issues broadly discussed during this period was the conversion of the economy from a capitalist to an Islamic economy order. Since the elimination of interest has generally been the first step in the Islamisation of the economy, more attention should be given to the formation and the operation of the Islamic banks. The establishment and operations of Islamic banks have raised many theoretical and conceptual considerations. Muslims economists have developed theoretical models of an interest-free economic system and analysed the implications of the abolition of interest on economic growth, allocation of resource and distribution of income. Practising bankers have also made valuable contribution to literature on interest-free banking.

2.2 Prohibition of Riba (Interest)

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra 1982), it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in the Islamic order.

The Holy Qur'an explicitly and emphatically prohibits riba. There is complete unanimity among all schools of thoughts in Islam that the riba stands for interest in the all its types and forms. The absolute prohibition is confirmed by Verses in the Chapter of al-Baqarah in which Allah describes the creditor's right to recover no more than his capital is highlighted.

The prohibition of riba is mentioned in four different revelations in Qur'an. The first revelation emphasises that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelations enjoins to stay clear of interest for the sale of their own welfare.

The fourth revelation is in Surah Al-Baqarah, Verse 275–281 , establish a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay. It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet (Ariff, 1988).

The prohibition of interest is also cited in no uncertain terms in Hadith (saying of the Prophet). The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt (Ariff,1988).

Article 85 of Majallah Al-Ahkam Al-Adliyyah states "the benefit of a thing is a return for the liability for loss from that thing", followed by article 87 which highlights that "the detriment is as a return for the benefit" and finally article 88 explains that "the burden is in proportion the benefit and the benefit in proportion to the burden". Hence in any transaction that could create benefit or profit to one party or both parties to a contract, the benefit he will be receiving should be met with a corresponding possibility of risk and liability even momentarily or so minimal to justify the benefit he will earn out of that transaction. This principle can easily make a distinction between interest which is unlawful and profit which is lawful since benefit in lending activities unlike in trading is not commensurate with the liability of the benefiting party that is the lender. In other words, in trade transactions, a seller may justify the profit element due to this efforts, skill, management, services rendered and the risk he has to bear in the event that the goods may not be sold successfully.

In the article entitled "*The Nature Of Riba And Its Treatment In The Qur'an, Hadith and Fiqh*", Muhammad Umar Chapra(1992) defined the meaning of riba as increase, addition, expansion or growth. In the Shariah, riba technically refers to the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. The term riba used in the shariah in two senses, namely riba al-nasi'ah and riba al-fadl.

According to the article, the term nasi'ah comes from the root nasa'a which means to postpone, defer or wait and refers to the time that is allowed for the borrower to repay the loan in return for the 'addition' or the 'premium'. Hence riba al-nasi'ah refers to the interest on loans. The prohibition of riba al-nasi'ah implies that the fixing in advance of a positive return on a loan a reward for waiting is not allowed in the Shariah.

The riba al-fadl which is the second sense has been used and encountered in hand-to-hand purchase and sale of commodities. It covers all spot transaction involving cash payment on the one hand and immediate delivery of the commodity on the other. The discussion of riba al-fadl has arisen from the ahadith requiring that if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged spot and be equal and alike. What is essentially being required is justice and fair play in spot transitions, the price and the countervalue should be just in all transaction where cash payment is made by one party and the commodity or service is delivered reciprocally by the other.

The prohibition of riba al-fadl is thus intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back doors to riba because in the Islamic shariah, anything that serves as a means to the unlawful is also unlawful.

Thus riba al-nasi'ah and riba al-fadl are both essential counterparts of the verse "God has allowed trade and prohibited riba" (2:275). While riba al-nasi'ah related to loans and is prohibited in the second part of the verse, riba al-fadl related to trade and is implied in the first part.

Dr Mohd Daud Bakar(1996) in his article entitled "*Contract Of Exchange In Islamic Law Of Transactions As Applied In Interest-Free Banking System*" emphasised that Islamic banking and finance cannot deal with money directly to generate income or profit. On the contrary, Islamic banking and finance could generate the profit through either commodity transactions or combination of both capital and effort. Since the approach of profit and loss sharing is bound to face the issues of risk management and moral hazards, the most likely workable approach is to deal with commodity trading. Trading which is basically based on the contract of exchange poses no legal constraint since it is lawful to generate profit as long as it does not contravene the principles of Islamic law governing trading. This is because the benefit or profit accruing to one party is always justified on the basis of his liability of risk and burden.

2.3 Equitable-Sharing of Risks and Gains Encouraged by Islam

The basis of cooperation between capital and enterprise which Islam cherishes is equitable sharing of the risks and gains between them. The essential element of "trading" is that the return on capital employed depends upon actual operating results of the business undertaken. To apply this principle to modern modes of business and finance it will be necessary to completely reorganise the currently prevailing banking practices and to replace interest by a system of profit and loss sharing (PLS).

Under this system banks and other financial institutions will not get a fixed rate of return on finance provided by them but will instead share in the profit and loss of the business enterprises to whom they provide the financial resources. Similarly, those entrust their savings to banks and other financial institutions for a specific period will share in the profit and loss of banks. Replacement of the fixed interest system by a system of PLS would have far reaching consequences and its successful functioning can greatly help in achieving greater social justice which is a cardinal objective of an Islamic society.

Mohamed Ariff (1988) said that the Islamic bank on interest does not mean that capital is costless in an Islamic system. Islam recognises capital as a factor of production but it does not allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit-sharing can be a viable alternative (Kahf 1982a and 1982b). In Islam, the owner of the capital can legitimately share the profits made by the entrepreneur. What makes profit sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined.

It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit sharing ratio to the investor, other things being equal. One dissenting view is that the substitution of profit-sharing for interest as a resource allocating mechanism is crude and imperfect and that the institution of interest should therefore be retained as a necessary evil (Naqvi 1982). However, mainstream Islamic thinking on this subject clearly points to the need to replace interest with something else, although there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest.

Dr Ziauddin Ahmad (1992) in his article entitled *"Conversion Of Interest Based Banking To Islamic Interest-Free Banking"* has commented that the form and content of Islamic Banking practices should be deduced from the teachings of Islam. Delineation in the Holy Qur'an of the practice of interest as an act of " war with Allah and His messenger " provided a clue to the philosophy behind the prohibition of interest on loans taken for consumption purposes is clearly based on the ethical consideration that people living in an Islamic society should help each other in times of need by lending money without charging extra for it. Hence, charging of interest on loans taken for consumption purposes amounts to taking advantage of a man's inferior economic position and is repugnant to the spirit of Islam whose underlying philosophy is one al-Adl Wal Ahsan.

There seems to be two broad alternatives presented pertaining to the operating procedures of Islamic banking. The first is to decree that no return would be paid on any type of deposits in banks and all loans and advances will be provided on an interest-free basis. Under this scheme the bank would be only be allowed to recover a service charge from their clientele just sufficient to cover their operating expenses. However, this alternative cannot be commended as it can have adverse consequences for economic growth and allocation efficiency.

The other alternative is that banking should be conducted on the basis of profit/loss sharing. In Islam there is no objection in getting a return on capital if the provider of capital enters into a partnership with the entrepreneur and is prepared to share the business risk. In other words, the depositor of the bank may not be guaranteed a predetermined return on their saving but they would be entitled to a share in the actual profits earned by the bank. Similarly, the bank would not be entitled to claim a predetermined return on the capital provided but it could enter into a profit/loss sharing arrangement.

2.4 Deposit Facilities

Like conventional banks, besides their own capital, Islamic banks are dependent on the depositors' money as a major source of funds. There are four types of deposit accounts operated by the Islamic banks namely current account, savings account, investment account and special investment account. As for the current account, the Bank operates on the basis of Al-Wadiah (Trustee) principle with no distribution of profits. Saving deposits are also received under the same principle with the distribution of profits at the discretion of the bank. In the case of investment account, the Bank accepts deposits from depositors with the intention to make investment based on the principle of Mudarabah (Haron, Shanmugam 1997).

2.4.1 Demand Deposit

The Bank will receive demand or current account deposits in a similar manner as practised by the conventional banks. The owner is entitled to receive his or her funds on demand and to write cheques on the account which transfers legal ownership of funds to others. The purpose of using this facility is for convenience or to make payment for daily commitments. The Bank does not pay any returns on this account but instead account holders shall be levied with the stamp duty on cheques issued. In general, there are two principles used by Islamic Bank in providing this facility, that is, Qard Hassan and Wadiah.

2.4.2 Savings Deposits

The Bank also accepts savings deposits from depositors who wish to save money for precautionary motive or safe-keeping. There are three Shariah principles used by Islamic banks for savings account namely Qard Hassan, Wadiah and Mudarabah. As with the current account deposits, the Bank can obtain specific consent from the depositors to use the funds in its business activities as long as it does not contradict the principles of Shariah. One of the unique feature of this account in Islamic Banking is that the depositor is not entitled to any share of the Bank's profit. However, the Bank at its own discretion shall distribute some of the profits derived from use of the savings account holders' funds.

2.4.3 Investment Deposits

All investment deposits accepted by Islamic Banks are governed by the principle of Mudarabah. It is one of the concept associated with the Profit and Loss System (PLS). Within this context, BIMB acts as the "entrepreneur" and the customer as the "provider of capital" and both shall agree on the distribution of the profits generated from the investment of the funds. The agreement between the bank and the depositor on how the profits and losses will be distributed is made at the beginning of the